PR24

PR24 and beyond: Discussion paper on outcome delivery incentives

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United Utilities response to Ofwat's discussion paper

United Utilities

Water for the North West

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1. Introduction

United Utilities welcomes the opportunity to comment on Ofwat's publication 'PR24 and beyond: a discussion paper on outcome delivery incentives'.

We are generally supportive of Ofwat's ambition to revise the standard ODI rate formula – this approach is broadly consistent with the approach we promoted at PR19. We would however advocate the retention of marginal costs as a useful cross-check against the resultant incentive rate calculations, something which we found helpful at PR19. To aid this, we suggest that a sector wide data exercise could produce improved marginal cost calculation guidance. Such a step should help to improve comparability and consistency between companies.

We agree with Ofwat's views on the difficulties of basing asset health incentive rates on marginal benefits and see merit in a top-down approach, based on relative customer priorities. We also recognise Ofwat's concerns around the apportionment of any top-down incentives and see the importance of added customer protections, such as targeted caps and collars and cross-checks with marginal costs. A top-down approach could also be applied for the development of targeted caps and collars and the overall review of each company's performance commitment package.

Finally, based on our experience to date with enhanced incentives, we consider that the performance threshold has been set so high as to mean they have limited incentive properties. UUW's own experience is that despite delivering a step-change improvement in performance on pollution incidents - our only metric with enhanced rates - we have been unable to access the enhanced incentives. We believe that for PR24, either access to enhanced incentives should be set at a more achievable level or they should be discontinued. Removing enhanced ODI rates will remove additional complexity, providing for easier communication with customers and stakeholders and allowing a clear focus by management on achieving stretching but attainable performance commitments, supported by suitable incentive rates.

2. Purpose of ODIs

Q1 Do you have any comments on what the purpose of ODIs should be at PR24?

We regard ODIs as an essential part of the regulatory framework, critical to ensuring that companies have effective incentives to improve services delivered to customers. We support the inclusion of meaningful financial incentives as part of the price review package and view them as an important driver of improved performance in areas that customers value. Incentives can come in various sizes - some metrics may naturally lean towards a lower value incentive, as customers may place varied weights on different performance areas - smaller incentives should not necessarily lead to outcomes being dismissed outright, particularly if they support areas of service which customers and stakeholders care about.

Set at the right level, ODIs can be effective in driving companies to successfully balance competing pressures in allocating cost and effort to different areas of customer service delivery. To do this effectively, we would advocate that incentives should be evenly balanced and symmetrical in both their under- and out-performance rates, as opposed to the current asymmetric weighting towards larger underperformance valuations. Incentives should enable companies to rationally assess the investment options open to them and decide what action to take.

Alongside the right incentive value, setting the right performance target is also crucial to ensuring the effectiveness of incentives and avoiding inefficient investment decisions, to the detriment of company, customers and stakeholders. To this end, we would promote:

- companies being excluded from informing comparative targets for a particular outcome if their performance (in general) across other areas of performance is poor – this may indicate that the level of performance being achieved on the particular outcome is either (a) due to unusually beneficial operating conditions (that are not available to other companies) for that measure, or (b) an inappropriate level of management focus on that particular measure, to the detriment of performance elsewhere; and
- the use of econometric modelling to test the equivalent efficient level of performance for each company – rather than (at present) asserting that common performance is equally achievable by all companies, and assuming that any differences in cost requirement to meet those common targets is allowed for within the cost assessment process. We have recently presented compelling evidence on this in relation to internal sewer flooding targets, which we plan to publish on the Future Ideas Lab in the near future.

3. Options for standard ODI rates – Bottom-up approaches

Q2 Do you have any comments on our observations on the standard ODI rate formula and how we are considering revising it?

We support Ofwat's proposal to remove marginal cost from its standard ODI rate underperformance formula as a helpful step in reducing complexity.

We support Ofwat's approach of using marginal benefits as the primary driver within incentive calculations, but consider that consistently calculated marginal costs should continue to be calculated. We advocate that marginal costs should be used as a cross-check against the marginal benefit based incentive rate calculation, much as UUW employed at PR19. This should ensure that companies are not incentivised to pursue benefits that are substantially outweighed by costs, as this would appear unlikely to provide the best value outcomes for customers.

Wide variations in marginal costs, some of which were seen at PR19, can be overcome by a sector wide data exercise to develop guidance on calculating marginal costs. Whilst some explainable variation between companies' marginal costs will persist, the existence of robust and consistently calculated marginal costs could offer scope to be a sense-check on incentive rates developed from customers' marginal benefits.

We agree with Ofwat's PR24 proposal that a share – rather than the whole amount – of the marginal benefit should be included in the incentive rate. However, we would argue that the same sharing rates should be applied to both out- and under-performance incentive rates. This would enable the calculation of symmetrical incentive rates – this symmetry will better ensure that incentives are simple, transparent and effective. We consider that sharing rates should be based on AMP8 company totex sharing rates, so that the linkage is maintained between company expenditure (or saving) and performance. We adopted this approach at PR19 of an assumed 50% rate of marginal benefits, with an added cross check for customer protection, to ensure that marginal benefits exceeded marginal costs.

Q3 What are the risks of unintended consequences from this approach? How can they be mitigated?

We consider that using marginal costs as a cross check to the marginal benefit should protect against unintended consequences from this revised bottom-up approach, in particular to identify where there is a risk that marginal cost may substantially outweigh marginal benefits, and hence lead to poorer value outcomes for customers. This was the approach we took at PR19.

Further protections can also come from, for example: the use of targeted caps and collars; and, an overall check of the total ODI package against a specified top-down +/-x percentage (%) of the RoRE range. It is important that each company's RoRE range is calculated consistently. To achieve this, we advocate that Ofwat should calculate RoRE ranges from industry-provided data as to the ranges for individual outcomes, which was what ultimately occurred at PR19. This will ensure that companies' RoRE ranges are consistently calculated, and not subject to variation introduced by different companies' methods to aggregate individual risk ranges into an overall RoRE range. Alternatively, such functionality could be built into Ofwat's financial model, to ensure there is consistent calculation of RoRE ranges between companies.

Q4 Do you have any comments on using a bottom-up approach based on marginal benefits for setting ODI rates?

We consider that a bottom-up marginal benefits based approach can best be applied to customer-facing and environmental PCs. Due to the difficulties in ascertaining customer views on asset health-related benefits, we would support that a different approach should be taken for these measures, such as a top-down approach.

Q5 Do you have specific comments on setting ODI rates for asset health-related PCs?

We find it difficult to fully answer questions on how asset health should be incentivised absent Ofwat's response to UKWIR's soon-to-be-published paper on the matter. Understanding how Ofwat intends to apply UKWIR's proposals in the PR24 methodology will enable us to fully consider issues such as how to effectively incentivise asset health.

We think it is unlikely that marginal benefits would be the best approach to calculate asset health incentive rates. This is because it is very difficult to sufficiently inform customers about asset health in order for them to then give an informed answer about the benefits in this area. At this stage, we think that a top-down approach could be utilised instead. However we have reservations over this method - allocating any top-down incentive pot must be done with care to avoid generating perverse incentives. For example, set too high, a company could target outperforming an incentive not because customers value that aspect or because such action will help to ensure improved asset health, but because that is the particular area where outperformance payments are easier to earn. Inappropriately apportioned incentives could also create perverse incentives for under-performance, with companies choosing to take no action to avoid asset health deterioration in certain areas, because the underperformance incentive rate is set too low. Neither of these scenarios would be in the long term best interests of customers. We suggest that allocations could be based on customer priorities with a cross-check to marginal costs, calculated through improved guidance. Caps and collars can also be employed to protect against perverse incentives.

We recommend that incentive rates are most effective when applied symmetrically for both out- and under-performance. There is some suggestion in Ofwat's discussion paper that asymmetric out- and under-performance rates could be appropriate for certain asset health-related PCs. We consider that all incentive rates must be symmetrical to better ensure that they are simple, transparent and effective, and help create a balanced risk and return package overall.

Another approach to setting ODI rates on asset health-related PCs could be a bottom-up approach using marginal costs. We expect that this approach provides the most direct way of supporting asset health investment at a proportionate level without significantly over- or under-incentivising companies. This marginal cost approach would be most appropriate for network asset health measures, such as mains repairs, sewer collapses and blockages.

Whilst we recognise that there were examples of wide variations between companies' marginal costs at PR19 we think that these could be reduced by developing guidance on calculating marginal costs. This guidance should be developed through a sector wide data exercise to ensure the most consistent data quality in calculated marginal costs. Such guidance could facilitate better outputs with less unexplained variance; whilst all companies would have different marginal costs, this cross-company approach should produce a narrower range of variation.

Variances in marginal costs may arise because a full marginal cost may be formed from two parts, the incremental reactive costs associated with resolving an incident, minus the incremental proactive costs associated with a change in performance. Companies may have previously provided either or both elements in their marginal cost. Clearer guidance could overcome this issue and produce more consistently calculated marginal costs.

The proposed guidance for marginal cost calculation could involve developing a standardised marginal cost case, where companies would provide limited and closely defined cost rate data. An example of a standardised case for mains repairs, could assume that (for example):

- the trigger threshold for potential mains rehabilitation is a sustained rate of two repairs per kilometre per year;
- most repairs happen in 100mm distribution mains;
- the most appropriate proactive intervention would be rehabilitation of the main;
- any rehabilitation programme is profiled evenly throughout an investment cycle;

- once identified, the mains do not deteriorate further, i.e. they remain at circa two repairs per kilometre per year; and,
- marginal cost assessment is limited to the investment period.

With these assumptions the marginal cost is then only dependent upon the rate for rehabilitation of 200m of the 100mm pipe and the rate for reactive mains repair. The calculation of marginal cost within the investment period would be 200m of rehabilitation, minus the cost of a reactive repair. A similar approach could be developed for each of the network asset health performance commitments. However, due to the much wider range of proactive interventions available, marginal costs for treatment-based asset health performance commitments would be harder to develop quickly.

4. Options for standard ODI rates – Top-down approaches

Q6 What are your views on using top-down allocation approaches for setting ODI rates or for other uses?

Ofwat states that an alternative to setting ODI rates on an individual PC basis is using a 'top-down' approach, starting at the company level. Under this approach, Ofwat would start with intended maximum ODI payments for individual or groups of PCs, either expressed in £million or a percentage of regulatory equity.

If an appropriate methodology of apportionment can be agreed, then the key benefit of this approach would be using customers' preferences to inform the overall size and relative balance of companies' incentive packages, which customers may find easier, and more meaningful, to engage with than questions about their willingness to pay for specific service improvements. As included in our response to question 5, we can see that employing this top-down approach to asset health incentive rates would be preferable to a bottom-up approach based on marginal benefits. However, allocating the top-down incentive pot must be done with care to avoid perverse incentives. Allocations could be based on customer priorities with a cross-check to marginal costs, calculated through the refined guidance which we advocate in our response to question 5. We also advocate that a sector wide data exercise could be undertaken to help inform this allocation method.

Q7 How would we ensure that the performance increments for individual PCs are sufficiently robust and protect customers?

When using a 'top-down' approach to setting ODI rates there is an inherent risk that the size of incentives and ODI rates will arbitrarily differ between companies, particularly if the top-down payments are based on a proportion of regulatory equity (which reflects overall investment in water and wastewater since privatisation, not the current average or incremental cost associated with a particular service attribute). Caps and collars may therefore be needed to protect customers. A top-down approach could be utilised to inform how caps and collars are set for individual or groups of PCs. This option could be utilised consistently between companies, either as £million or as a percentage of regulatory equity.

We consider that this approach should help to protect customers from companies looking to fund large asset health programmes beyond assessed affordability constraints. This top-down approach would also provide a simple way to manage any concerns around diminishing returns from asset health investment.

5. Enhanced ODIs

Q8 Should we retain enhanced ODIs at PR24? If we do, should they apply to all companies? And which PCs should have enhanced ODIs?

Based on our experience to date with enhanced incentives, we consider that the performance threshold has been set so high as to mean they have limited incentive properties. Should enhanced ODIs be retained at PR24 then they need to be set at a more achievable level, stretching but attainable, or otherwise be discontinued. Removing enhanced ODIs will remove additional complexity from PR24. We consider that they add an unnecessary level of complexity to financial incentive calculations and therefore their removal should provide for easier communication with customers and stakeholders. We have also observed that application of standard incentive rates has been effective at delivering performance improvements across the sector at both PR14 and PR19, without the need for additional enhanced rates on the overwhelming majority of metrics.

Notwithstanding the limited dataset, the thresholds set across the sector which trigger application of enhanced incentives initially appear to have been set at levels which are unachievable for most companies. No company has been able to access these enhanced incentive rates in year one of AMP7. To act as effective incentives, enhanced ODIs need to be stretching but attainable, within the reach of companies. If this continues to be the case for the rest of the AMP7 period, then this effectively renders the enhanced incentives redundant. We consider that industry effort would be better spent on ensuring that for AMP8 standard ODI rates are set appropriately and consideration is made to ensuring that the associated performance targets are equally achievable by all companies, after accounting for the differential impact of exogenous factors on the efficient level of company performance.

If enhanced ODI rates are to be retained at PR24, then the decision of which metrics they should be applied to should be via agreement with the individual companies and be by exception. We believe that universal application to a potential sub-set of common performance commitments would lead to the extreme situation of both the worst-performing and frontier companies being unduly penalised and rewarded, potentially without any notable step-change in their performance. This is especially acute where elements of performance are beyond management control.

Q9 How should we approach assessing and setting enhanced ODIs at PR24?

As described in our response to question 8, we consider that should enhanced ODIs be retained for PR24 then they must target stretching but attainable performance levels or otherwise be removed. Whilst it may initially appear that performance levels being both stretching and attainable may be non-complimentary objectives, we consider that this could be calculated on certain measures where robust historical industry datasets are available. Should they be retained, then they need to be applied by exception only and through individual company agreement. In addition, we consider that if they are retained, then they should only be accessible to companies who are performing well in general, to avoid the risk of inappropriately incentivising companies to overly focus on a single measure, at the expense of poor performance elsewhere.

Q10 For water companies: how have enhanced ODIs influenced your company's decision making around achieving high performance?

For AMP7 we have enhanced financial incentives on a single performance commitment, pollution incidents. This measure utilises a calendar year assessment and in 2020 we achieved our best ever performance in this metric. We forecast to continue that trend and achieve an even better level of performance in 2021, striving as always to deliver the best performance we can. Enhanced ODIs, in this case, are set at such a stretching level that they tend to have limited incentive properties. Instead, it is the drive to continually reduce pollution incidents and protect the environment that has been our primary focus. This focus is facilitated through a number of strategic initiatives

and targeted approaches, covering topics such as culture, systems thinking, training and maintenance. This approach culminated in the production of an overarching pollution incident reduction plan (PIRP) which is available via our website[1]. It is the combination of this drive and focus which has led to us achieving our best ever performance for this commitment, rather than simply the possibility of earning enhanced ODI rates.

[1] https://www.unitedutilities.com/globalassets/documents/pdf/pollution-incident-reduction-plan_september-2020.pdf

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